

## 5.0 Philadelphia Suburban and Pennichuck Corporation

### 5.1 Philadelphia Suburban Corporation

The Philadelphia Suburban Corporation (PSC) will be the largest American-owned water utility in the United States when American Water Works sale to RWE GmbH (a German conglomerate) is completed next year. PSC is a holding company that owns some utilities directly but most are owned indirectly through its subsidiaries, Pennsylvania Suburban Water Company (PSWC) and Consumers Water Company (CWC). PSWC was set up in 2001 to operate utilities formerly owned directly by PSC. CWC was purchased in 1999.

### 5.2 PSC Growth Strategy

Individual utility companies (especially water and sewer utilities) are not ordinarily considered to be growth companies since there is typically little increase in the rate of consumption by individual customers and in fact there are often incentives for individual customers to reduce consumption. Growth in annual unit sales may be on the order of 1-2% except in urban core areas where consumption can be expected to be level or in extreme cases to actually decline. The growth that does occur is usually through extensions of services at their peripheries.

PSC has a “continuing growth-through-acquisition” strategy, which after 10 years, has resulted in more than 90 acquisitions and growth ventures.”<sup>1</sup> With this strategy, its earnings have grown by 16.8% per year over the last five years although the number of customers served has grown by only 3.5% per year and total assets by about 9.5% per year.

PSC has observed that there are some 50,000 water systems in the U.S. today from which to continue making acquisitions. In May 2002, Philadelphia Suburban announced an agreement to acquire the Pennichuck Corporation by merger and in June 2002 announced a deal to purchase with cash the Aqua-Source Corporation from DQE (a holding company whose primary asset is the Duquesne Light Company, an electric utility in the Pittsburgh area).<sup>2</sup> These acquisitions are consistent with their

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<sup>1</sup> Philadelphia Suburban Corporation 2001 Annual Report

<sup>2</sup> Although Philadelphia and Pennichuck intended their merger to pay a premium to Pennichuck stockholders, Aqua-Source is being acquired for about 80% of its book value. DQE is a holding company formed in the hey-day of electric deregulation when many electric utilities made a serious effort to diversify into a number of regulated and non-

corporate strategy. Indeed, to maintain a pattern of growth in earnings, PSC intends to continue to acquire new utility properties.

### 5.3 Characteristics of the Sale

As a small, regional water company the Pennichuck Corporation has experienced gradual organic growth as well as acquisitive growth with the properties now assembled into the Pennichuck East Utilities (PEU). PEU is composed of part of the Consumers New Hampshire Water Company that remained after the Town of Hudson took over that part of the utility within its borders. These properties had been heavily over-capitalized and Hudson was forced to sell them for about half of book value. Pennichuck has also acquired some smaller community systems as well as the 600+ customer Pittsfield Aqueduct Company.

When the deal to merge was struck by Pennichuck with Philadelphia Suburban, it meant that stockholders would receive a premium of about 18% on the transaction.

The merger agreement calls for exchanging enough Philadelphia Suburban shares for Pennichuck shares so that Pennichuck shareholders receive shares worth \$33 per share provided that Philadelphia's recent average share price was between \$23 and \$25 per share. If the Philadelphia share price is more than \$25, the exchange ratio is 1.32 shares per share of Pennichuck stock and if less than \$23, 1.45 shares.

At the time of the merger announcement, Philadelphia Suburban's stock had been trading for approximately \$24 per share and Pennichuck's was approximately \$27 per share. Under the terms of the merger, each share of Pennichuck stock would have to be exchanged for 1.38 shares of Philadelphia Suburban stock, which means each shareholder would exchange a security worth \$27 for a security worth \$33. As might be anticipated, the market quickly revised its valuation of Pennichuck to nearer \$33 per share.

Since the announcement of the merger, the stock market has changed dramatically and the ownership structure of Philadelphia Suburban has also changed.

In April 2002 the French company, Vivendi Environmental, which is owned, in turn, by Vivendi Universal, another French company with major

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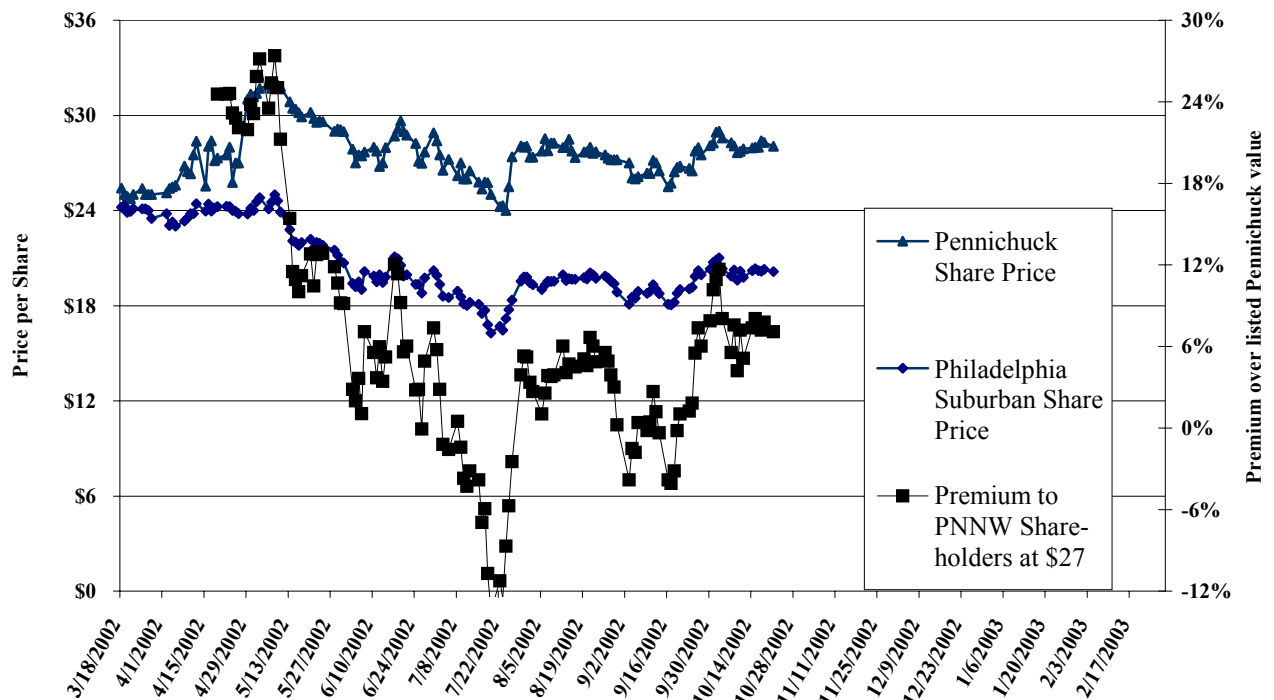
regulated industries with varying degrees of success. DQE today is desperate for cash with which to complete an electric generating plant it needs to comply with reliability rules in the Pennsylvania electric market and is apparently willing to leave the water utility business at a loss to maintain its core business.

holdings in entertainment and communications, owned approximately 17% of the shares of Philadelphia. Vivendi was experiencing severe cash flow problems and announced its intention to sell its shares in Philadelphia. Despite efforts by Philadelphia to shore up its stock price by guaranteeing purchase of some of the shares, its stock price declined. Later in the year, Philadelphia's stock suffered the same declines experienced by the stock market in the summer of 2002.

By October 21, 2002 the exchange ratio would have represented a premium of about 2.5% to Pennichuck stockholders based on Philadelphia Suburban prices of \$20 per share and Pennichuck prices of \$27 per share which would result in Pennichuck shareholders receiving only \$28.70 of Philadelphia Suburban stock for each Pennichuck share. Pennichuck's stockholders are expected to vote on whether to accept the merger proposal early in 2003.

Figure 5.1 shows the average closing price for Philadelphia Suburban that would have been used to calculate the exchange ratio each day since shortly before the merger announcement.

Figure 5.1  
Premium to Pennichuck Stockholders



## 5.4 Portrait of the Merged Companies

Assuming the merger is consummated, Pennichuck stockholders will receive shares of Philadelphia Suburban stock as described above and Pennichuck will become a wholly owned subsidiary of Philadelphia. Initially at least, Pennichuck will continue to be structured as it is at present, holding in turn the five Pennichuck subsidiary companies. The three regulated utilities will continue to be regulated by the New Hampshire Public Utilities Commission.

**There will continue to be a Board of Directors for Pennichuck but all its members will be appointed by Philadelphia Suburban and will probably be employees of the company.**

Table 5.1 on the following page shows the effect Pennichuck will have on several key statistics of Pennsylvania Suburban after the merger. The merger will increase the value of the physical assets by 5.4%, the gross revenue by 8.3% and net income by 6.7%. Most importantly to Philadelphia, the return on equity and on total capital will remain unchanged, which means there will be no dilution of earnings because of this merger.

**In proposing this merger both Philadelphia Suburban and Pennichuck say that ratepayers will benefit from the economies of scale that will reduce costs of operation.**

**There probably will be little such savings for the following reasons:**

**Cost of Debt.** While PSC might be able to borrow at favorable rates, the company presently requires its subsidiaries to borrow in their own names. As of December 31, 2001, PSC was paying 7.7% interest on its debt while Pennichuck pays only 7.3%.

**Cost of Materials.** Philadelphia's subsidiary Pennsylvania Suburban Water Company can buy materials such as pipe, valves and hydrants at a lower unit cost than Pennichuck. Pennichuck buys only small quantities of such items, however, for repair work. Like most water utilities, it is not cost-effective for Pennichuck to maintain a construction capability and it contracts for most construction work. The major contractors available to Pennichuck can furnish material, equipment and labor for construction projects at costs no greater than if the utility built projects with its own equipment, material and labor.

**Table 5-1 Selected Data for the Merged Pennichuck Corp. and Philadelphia Suburban Corp.**

As of 12/31/01	Philadelphia Suburban (PSC)	Pennichuck Corp.	Merged Companies	Change in PSC
Net Utility Plant	1,368,115,000	73,960,044	1,442,075,044	5.4%
Contributed Property (CIAC)	130,684,000	17,113,302	147,797,302	13.1%
Gross Revenue	300,188,000	24,920,628	325,108,628	8.3%
Gross Utility Revenue	293,228,000	<b>18,494,905</b>	311,722,905	6.3%
Gross Non-utility Revenue	6,960,000	5,342,578	12,302,578	76.8%
Net Operating Income	134,940,000	<b>15,285,341</b>	150,225,341	11.3%
Net Income	59,911,000	<b>4,040,738</b>	63,951,738	6.7%
Total Interest	39,859,000	1,980,926	41,839,926	5.0%
Number of Utility Customers	567,922	28,400	596,322	5.0%
Number of Non-Utility Customers	34,588		34,588	0.0%
Gross Utility Revenue/Customer	516	651	523	1.2%
Net Utility Plant/Customer	2,409	2,604	2,418	0.4%
Utility Plant net of CIAC/Customer	2,179	2,002	2,170	-0.4%
Gross Non-utility Revenue/Customer 201				
Long Term Debt	516,520,000	27,071,798	543,591,798	5.2%
Preferred Stock @ par	1,116,000		1,116,000	0.0%
Total Debt	517,636,000	27,071,798	544,707,798	5.2%
Retained Earnings	149,682,000	13,544,696	163,226,696	9.0%
Other Equity	323,035,000	17,178,891	340,213,891	5.3%
Total Equity	472,717,000	30,723,587	503,440,587	6.5%
Total Capitalization	990,353,000	57,795,385	1,048,148,385	5.8%
Cost of Debt	7.7%	7.3%	7.7%	
Return on Capital	10.1%	10.4%	10.1%	
Return on Equity	12.7%	13.2%	12.7%	

Note: Bold figures are Pennichuck's reported 2001 data adjusted to reflect the additional income from its most recently approved rates.

**Management Overhead.** Many of the costs associated with investor relations and stock issuance will be transferred from Pennichuck to Philadelphia. Philadelphia has some engineering and tax preparation expertise available beyond those presently possessed by Pennichuck. Philadelphia charges back those costs to its subsidiaries. The charges in 2001 were \$8,417,000 or approximately 2.8% of gross revenues. **Applied to the Pennichuck Utilities' gross revenue of \$17,228,830, this would**

**be a management fee of \$482,407 compared to the \$198,451 charged by Pennichuck to its subsidiaries in 2001.**

**Reinvestment of Earnings.** Philadelphia's corporate policy is to have equity as 50% of the total capital of its subsidiaries. Pennichuck is presently about \$2,300,000 less than that level. Higher equity means higher required rates of return for a utility because equity holders (stockholders) require higher returns than do lenders. **The upward adjustment in the equity portion will ultimately translate into higher rates for ratepayers.**